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The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction

Dr. Rita de la Feria, Senior Research Fellow*

In most countries applying a value added tax (VAT) system, the activities and transactions undertaken by public sector bodies are not subject to full taxation. The rationale usually invoked to justify lack of full taxation is of a mixed conceptual and political kind. On one hand, there is a view that the activities of those bodies are hard to tax and that, in practice, it is almost impossible to establish a single VAT treatment applicable to all of them. On the other hand, and more importantly, there is a perception that exclusion of the products supplied by public sector bodies from full taxation, achieves social and distributional aims. The rule under the EU VAT system is that supplies by public sector bodies are non-taxable. In practice, however, the VAT treatment of public sector bodies is extremely complex, giving rise to significant legal problems and economic distortions. The aim of this paper is to consider the current legislative framework, with special consideration being given to recent developments in this area, at both legislative and jurisprudential levels, in an attempt to determine whether they constitute positive progress, or whether together they represent a slow and subtle move towards a further deepening of the system's already existing flaws.

I. INTRODUCTION

In most countries that apply a value added tax (VAT), the activities and transactions undertaken by public sector bodies are not subject to full taxation.¹ They are either deemed to be zero-rated, exempt, outside the scope of VAT, or, as in the case of EU VAT system, and depending on various circumstances, all of the above. The rationale usually invoked to justify lack of full taxation is of a mixed conceptual and political kind. On one hand, public sector bodies have a diversified nature, engaging in different type of activities from policing to the provision of health and education services.² This has resulted in the view that the activities of those bodies are hard to tax and that, in practice, it is almost impossible to establish a single VAT treatment applicable to all of them.³ On the other hand, and more importantly, there is a perception

that exclusion of the products supplied by public sector bodies from full taxation, achieves social and distributional aims. The argument is two-fold: first, non-taxation should increase consumption of so-called merit goods; second, non-taxation of these products is said to diminish the natural regressivity of consumption taxes.⁴

There is a high-level of support for this mixed nature rationale, including from the International Monetary Fund (IMF).⁵ Yet, if the European experience is anything to go by, the practice of removing supplies by public sector bodies from the tax base will most likely give rise to significant problems.⁶ The rule under the EU VAT system is that supplies by public sector bodies are non-taxable, that is, they are outside the scope of VAT. In practice, however, the VAT treatment of public sector bodies is extremely complex,⁷ determined by the interaction of several different provisions of the Common VAT System

Notes

* Oxford University Centre for Business Taxation. I am grateful to Rick Krever for his comments on an earlier draft. The usual disclaimer applies.

¹ See R. Bird & P.P. Gendron, *The VAT in Developing and Transitional Countries* (Cambridge University Press, 2007), 86-87; A. Schenk & O. Oldman, *Value Added Tax – A Comparative Approach* (New York: Cambridge University Press, 2007), 282-283; and L. Ebrill et al., *The Modern VAT* (Washington DC: International Monetary Fund, 2001), 91 et seq.

² M. Aujean, P. Jenkins & S. Poddar divide government activities into three groups: redistribution of income and wealth; provision of public goods and services; and, provision of other goods and services which are similar to those supplied by the private sector, see 'A New Approach to Application of VAT to Public Sector Bodies', *International VAT Monitor* 10, no. 4 (1999): 144-149, at 144.

³ See L. Ebrill et al., n. 1 above, 92; and P.P. Gendron, 'Value Added Tax Treatment of Public Sector Bodies and Non-profit Organizations: A Developing Country Perspective', *Bulletin of International Taxation* 12 (2005): 514-526, at 516.

⁴ For a comprehensive discussion on the regressive nature of VAT, or otherwise, see G.N. Carlson & M.K. Patrick, 'Addressing the Regressivity of a Value-Added Tax', *National Tax Journal* 42, no. 3 (1989): 339-351.

⁵ L. Ebrill et al. note that 'in line with international practice, FAD [Fiscal Affairs Department of the IMF] recommends that certain services, principally health, education, and non-free financial services, be exempt from the VAT for policy and practical reasons', see L. Ebrill et al., n. 1 above, 65.

⁶ As explained by R. Krever the option in Europe is explained by the fact that 'when the traditional VAT was introduced in Europe, public bodies played a central role in many areas of the economy', see 'Designing and Drafting VAT Laws for Africa', in *VAT in Africa*, ed., R. Krever (Pretoria: Pretoria University Press, 2008), 9-28, at 26.

⁷ Complexity of a tax system has been defined as the sum of the compliance and administrative costs, see W.G. Gale & J. Holtzblatt, 'The Role of Administrative Factors in Tax Reform: Simplicity, Compliance, and Administration', in *US Tax Reform in the 21st Century*, eds R. Zodrow & P. Mieszkowski (Cambridge: Cambridge University Press, 2002), 179-214.

Directive (CVSD),⁸ and in particular Articles 13 and 132, and Annex I therein. Despite the acknowledged difficulties caused by the current system, for the most part, these provisions have remained unaltered since their introduction in 1977. The European Commission has in the past expressed an intention to revise the current legislative framework, but so far there have been no significant developments.⁹ In the meantime, the European Court of Justice (ECJ) has been extremely active in this area. Undoubtedly as a consequence of the complex legislative framework, the last two decades have witnessed a steady stream of references from national courts to the ECJ, the intensity of which seems to have increased over the recent years.

The aim of this paper is to consider the current legislative framework, assessing in particular whether the Court's intervention has been successful in dealing with difficulties arising from it, or whether more radical legislative reform is required. In doing so, consideration will be given to recent developments in this area, at both the legislative and jurisprudential levels, in an attempt to determine whether they constitute positive progress, or whether together they represent a slow and subtle move towards a further deepening of the system's already existing flaws.

2. THE EU VAT TREATMENT OF PUBLIC SECTOR BODIES

The general rule on the VAT treatment of public sector bodies is set out in Article 13(1), first paragraph of the CVSD, which establishes that public legal entities will be regarded as non-taxable persons, where they engage in activities or transactions as public authorities. In practice, this means that they will not charge any VAT on their supplies, but neither will they be entitled to deduct input VAT incurred on the supplies made to them. This basic rule is however subject to various exceptions, some of which are set out in Article 13(1) itself; others can be found in other provisions of the directive, namely Articles 2(1)(b)(i), 3(2)(a) and 132 and Annex I; and others yet result from the inter-connection between the different paragraphs in Article 13 and those others provisions. Overall, the VAT treatment of public sector bodies is dependent on the answers given to two fundamental questions: Is the

transaction taxable or non-taxable, and, if it is taxable, is it exempt or not exempt?

2.1. Public Sector Bodies: Taxable or Non-taxable Persons?

The first step towards establishing the VAT treatment of a particular activity / transaction undertaken by a public sector body is to determine whether the public sector body in question is regarded as a taxable person, or a non-taxable person, for the purposes of that activity.

2.1.1. General Rule: Public Sector Bodies Engaged in Activities or Transactions as Public Authorities

Under the first paragraph of Article 13(1) of the CVSD, where States, regional and local government authorities and other bodies governed by public law engage in activities or transactions as public authorities, they are regarded as non-taxable persons in respect of those activities or transactions, that is, those activities will be deemed to be outside the scope of VAT.¹⁰ Despite this apparent simplicity, the application of this provision does in fact give rise to many complications, notably due to the fact that the terms used are both unclear and susceptible to different interpretations.

There are two key elements to the provision: the identity of the supplier, 'bodies governed by public law', and the manner in which the supply is undertaken, 'activities or transactions in which they engage as public authorities'. It is now settled case-law that these two elements are cumulative, rather than alternative. In order for activities to fall within the scope of the first paragraph of Article 13(1), they must be both: undertaken by a body governed by public law; and, engaged in by that body, acting as a public authority. First established by the ECJ early on, in *Commission v. Netherlands*,¹¹ this approach has been consistently reiterated in later rulings. The rationale behind it seems to be the exceptional nature of the regime applicable to public sector bodies in general. In *Commission v. Netherlands*, the Commission had argued that the principle of tax on consumption, which underlines the EU VAT system, required the main rule in Article 13 to be interpreted strictly.¹² Although the Court did not state

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⁸ Council Directive 2006/112/EC of 28 Nov. 2006 on the common system of VAT, [2006] OJ L347/1.

⁹ See *A Strategy to Improve the Operation of the VAT System within the Context of the Internal Market*, Communication from the Commission to the Council and the European Parliament, COM(2000) 348 final, 7 Jun. 2000, at 11; and *Review and Update of VAT Strategy Priorities*, Communication from the Commission to the Council and the European Parliament, COM(2003) 614 final, 20 Oct. 2003, at 11.

¹⁰ It is important to note that the wording of the provision is largely based in the civil law traditional distinction between private and public law, something which is not present, at least with the same emphasis, on common law countries.

¹¹ Case 235/85, *Commission v. Netherlands*, [1986] ECR I 471. The Dutch Government had argued in this case that services should fall within the scope of that provision, where they are as regarded as acts of the public authorities, regardless of whether they are formally bodies subject to public law or not.

¹² *Ibid.*, at paras 16 and 17.

explicitly that that provision should be interpreted strictly in that case, it did confirm this in later judgments, such as *Carpareto Piacentino and Rivergaro*.¹³

In light of the cumulative nature of the two elements of the main rule in Article 13(1), first paragraph, it is clear that its scope of application is dependent on the concept of ‘bodies governed by public law’ and the meaning of the expression ‘activities or transactions in which they engage as public authorities’. The difficulty however lies in the fact that both expressions have presented national courts with practical problems, resulting in various preliminary references being made to the ECJ over the last two decades. These have in turn allowed the Court to develop significant jurisprudence.

‘Bodies Governed by Public Law’

The Court has tended to define ‘bodies governed by public law’ in negative terms, that is, by establishing those which *are not* bodies governed by public law, within the meaning of the first paragraph of Article 13(1). In this context, the following have been deemed by the Court to be excluded from the scope of that provision:

- traders governed by private law (*Tolls Cases*);¹⁴
- bodies that are not part of the public administration (*Commission v. Netherlands*); and,
- bodies that carry out independent economic activities as part of the exercise of a liberal profession (*Commission v. Netherlands*).¹⁵

The ECJ has also ruled in *Ayuntamiento de Sevilla* that performance of acts falling within the prerogatives of the public authority is not sufficient to characterize a body as one governed by public law. It follows that, if public duties are entrusted to an independent third party, those activities do not, in principle, fall within the scope of the public sector bodies’ regime.¹⁶ The strict interpretation of the expression ‘bodies governed by public law’ had therefore the obvious effect of excluding all outsourcing situations from the scope of the main rule in Article 13.

Although such a move should not be deemed surprising, it gives rise to its own problems. Exclusion of outsourced services from the scope of the regime applicable to public sector bodies was not only consistent with the strict interpretation approach adopted by the Court in previous rulings, but arguably the most appropriate approach in light of the exceptional nature of that regime. Such consistency, however, comes at a price. As it will be discussed below, applying a distinct tax treatment to outsourced and non-outsourced situations will unavoidably give rise to further economic distortions.

‘Activities or Transactions in Which They Engage as Public Authorities’

The unclear nature of the expression ‘activities or transactions in which they engage as public authorities’ has given rise to considerable case-law and has been at the centre of most ECJ rulings on the regime applicable to public sector bodies.¹⁷ Although, in *Carpareto Piacentino and Rivergaro*, the Court ruled that it was for the national courts to determine which activities or transactions fulfil the conditions set out in Article 13(1), first paragraph,¹⁸ in that same judgment, as well as in subsequent ones, it provided some guidelines as regards the expression’s interpretation.

It clearly emerges from this jurisprudence that the main criterion for determining the scope of the expression ‘engaging as public authorities’ is the legal regime applicable under national law to the activity at issue. Public bodies are deemed to be engaging in activities as public authorities when they do so under a special legal regime, applicable to them, or where they make use of ‘public powers’. Public bodies will be excluded from the scope of the provision where they act under the same conditions as those applied to private bodies. This basic criterion, first outlined in *Carpareto Piacentino and Rivergaro*,¹⁹ has been consistently reiterated by the Court in later rulings, such as *Commune di Carpaneto Piacento and Others*, which was issued some months later,²⁰ and also in *Ayuntamiento de Sevilla*.²¹ Further guidelines on how to apply this criterion have been provided in more recent judgments and opinions,

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¹³ Joint cases 231/87 and 129/88, *Carpareto Piacentino and Rivergaro*, [1989] ECR 3233.

¹⁴ A series of cases, dating from the late 1990s and early 2000s, concerning the VAT treatment of tolls paid as consideration for the usage of roads, motorways and bridges. See cases C-276/97, *Commission v. France*, [2000] ECR I-6251; C-358/97, *Commission v. Ireland*, [2000] ECR I-6301; C-359/97, *Commission v. United Kingdom*, [2000] ECR I-6355; C-408/97, *Commission v. Netherlands*, [2000] ECR I-6417; C-260/98, *Commission v. Greece*, [2000] ECR I-6537.

¹⁵ See n. 11 above, at para. 23. This previous ruling seems to be at the centre of an application from the European Commission currently pending at the ECJ concerning the VAT treatment of services supplied by state legal officers, see case C-246/08, *Commission v. Finland*, [2008] OJ C209/29.

¹⁶ Case C-202/90, *Ayuntamiento de Sevilla*, [1991] ECR I-4247, at paras 19 and 20. This approach has been reiterated recently by the Court in case C-456/07, *Mihal*, Order of 21 May 2008; and again in case C-462/05, *Commission v. Portugal*, Judgment of 12 Jun. 2008, at paras 38–42.

¹⁷ It has also been subject of a European Parliamentary written question, see VAT exemption for bodies ‘acting as public authorities’ as defined in the Sixth Council Directive on VAT, Written Question 780/93 by Gary Titley to the Commission, [1993] OJ C288/35.

¹⁸ This approach has attracted criticism, see S. van Thiel, ‘EEC – Public Authorities as Taxable Persons for VAT’, *International VAT Monitor* 2 (1990): 28–34.

¹⁹ See n. 13, at paras 15 and 16.

²⁰ Case C-4/89, *Commune di Carpaneto Piacento and Others*, [1990] ECR I-1869.

²¹ Case C-202/90, *Ayuntamiento de Sevilla*, [1991] ECR I-4247.

more specifically it is clear that its application will not be dependent on the following considerations:

- type, subject matter or purpose of the activity (*Câmara Municipal do Porto*);
- ownership of property where activity is undertaken (*Câmara Municipal do Porto*);²²
- whether in fulfilling responsibilities exclusively allocated to it, the State makes use of civil law procedure (Advocate General Kokott in *T-Mobile and Hutchison 3G and Others*); and,
- whether the public body receives a high amount of revenue from its activity (Advocate General Kokott in *T-Mobile and Others* and *Hutchison 3G and Others*).²³

Thus, none of these are determinant factors.

2.1.2. Exceptions

The general rule in the first paragraph of Article 13(1) of the CVSD, according to which the activities undertaken by bodies governed by public law will be deemed to be outside the scope of VAT, where they have been engaged in by those bodies as public authorities, is subject to four exceptions.²⁴ Three of these exceptions limit the scope of the main rule, establishing that even where activities fall within the scope of that rule, they may still be regarded as taxable provided certain conditions are present, as follows:

- Where treating those activities as outside the scope of VAT would lead to significant distortions of competition (Article 13(1), second paragraph);
- Where certain activities are at stake, provided they are not carried out on such a small scale as to be negligible (Article 13(1), third paragraph and Annex I); and
- Where the activities in question are intra-Community acquisitions, above a certain threshold (Articles 2(1)(b)(i) and 3(2)(a)).

On the contrary, the final exception to the main rule seems to extend its scope. Where public sector bodies engage in activities not as public authorities, Member States may still regard them as falling under the scope of the main rule: where exempt activities, listed in certain articles of the CVSD (Article 13(2)), are at stake.

Open Clause Exception: ‘Significant Distortions of Competition’

Under the second paragraph of Article 13(1) the main rule in the first paragraph of the Article will not apply where its application would lead to significant distortion of competition. The clause’s objective is clearly to introduce an element of flexibility into the rigidity of the main rule and, as the Court itself has stated in *Halle*, to ensure fiscal neutrality.²⁵ In practice, however, the expression ‘significant distortions of competition’ has caused significant difficulties of interpretation and application. Perhaps for that precise reason, the ECJ ruled earlier in *Carpareto Piacentino and Rivergaro*, that Member States were not obliged to transpose the criterion literally, or to lay down precise quantitative limits for such treatment; they were, however, obliged to ensure that public bodies were treated as taxable in cases where the treatment as non-taxable persons could lead to distortions of competition.²⁶

The focus placed by the Court in that ruling on the aims of the provision, rather than on the means adopted to achieve those aims, has been re-emphasized in subsequent rulings. Recently, in *Gotz*, the Court ruled that Member States were free to define the relevant geographic market for the purposes of applying the open clause.²⁷ Some years before, in *Câmara Municipal do Porto* the ECJ had already ruled that Member States were free to define in their national legislation activities which were liable to bring about distortions of competition, leaving it to administrative authorities to apply the definition. Yet, this freedom did not extend to situations where a discretionary power has been given to an administrative authority to apply it.²⁸ Equally, this freedom is somewhat limited by the fact that in *Halle* the Court confirmed that a private person, who is in competition with a public body and alleges that the latter is undertaxed, is entitled to rely in Article 13(1), second paragraph, before the national court, that is the open clause has direct effect.²⁹

Most rulings regarding the interpretation of the second paragraph of Article 13(1) have therefore concentrated on the scope of the freedom of transposition given to Member States under that provision. Whilst very little has therefore been said about the scope of the expression ‘significant distortions of competition’ itself. Notable exceptions were the Opinions of Advocate General Kokott in *T-Mobile and Others* and *Hutchison 3G and Others*, and that of Advocate

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²² Case C-446/98, *Câmara Municipal do Porto*, [2000] ECR I-11435, at para. 22.

²³ Cases C-284/04, *T-Mobile and Others*, [2007] ECR I-5189 and C-369/04, *Hutchison 3G and Others*, [2007] ECR I-5247, respectively, Opinion of the Advocate General, at para. 124.

²⁴ The suggestion that Art. 13 of the CVSD was divided into main rule and exceptions was also put forward by Advocate General Mischo in joint cases 231/87 and 129/88, *Carpareto Piacentino and Rivergaro*, [1989] ECR 3233.

²⁵ Case C-430/04, *Halle*, [2006] ECR I-4999, at para. 24.

²⁶ See n. 13 above, at para. 24. A similar interpretation was adopted in *Comune di Carpaneto Piacentino and Others*, n. 20 above, at para. 13.

²⁷ Case C-408/06, *Gotz*, Judgment of 13 Dec. 2007, nyr, at para. 46.

²⁸ See n. 22 above, at para. 34.

²⁹ See n. 21 above, at para. 32.

General Maduro in *Isle of Wight and Others*. In *T-Mobile and Others* and *Hutchison 3G and Others*, Advocate General Kokott started by commenting on timing issues, noting that the effect on competition must, in principle, exist at the date of the transaction.³⁰ On the basis of previous ECJ jurisprudence, namely *Assurandor-Societetet*, a case concerning the application of exemptions,³¹ she seemed to acknowledge that the open clause in Article 13(1) could include within its scope distortions of competition, which the treating public sector bodies as non-taxable persons might give rise to in the future. However, she emphasized that, ‘the risk of distortions of competition must be real’.³² Although the risk of distortions of competition can be real even if no competitor is at present offering competing supplies subject to VAT, real risk is ruled out where there are no potential competitors due to the existing legislative framework.

The recent decision of the Grand Chamber in *Isle of Wight and Others*, which follows the previous Opinion of Advocate General Maduro, takes this approach further. The Court in this case was asked by the UK courts to decide, first on whether any distortion of competition is to be assessed at a local level, which requires the conditions of competition on the relevant market to be established, or whether it must be assessed solely in the light of the activity concerned, and secondly to clarify the meaning of the expressions ‘would lead to’ and ‘significant’, for the purposes of the second paragraph of Article 13(1). On the first point, Court emphasized the point made in previous rulings that the clause is to be interpreted as meaning that it is incumbent upon the Member States, within the framework of the discretion that is accorded to them for implementation of that provision, to determine on the basis of the activities concerned whether there would be a risk of distortion of competition. In this regard, the meaning of the expression significant distortions to competition ‘must be evaluated by reference to the activity in question, as such, without such evaluation relating to any local market in particular’.³³ More importantly, on the second point, the ECJ provided some clarification on the meaning of some of the expressions used within the clause: on the meaning of the words ‘would lead to’, it considered that they must be understood as including both actual competition and potential competition in so far as the possibility of the

latter is real and not hypothetical; as regards the expression ‘significant’, it contended that although it does not imply that the distortion of competition is trivial or exceptional, rather that it is out of the ordinary, the interpretation of the concept fell ultimately within the discretion of the Member States, so far as the interpretation complies with the objectives of the Directive.³⁴

Further guidance is likely to come soon, with two cases currently pending before the ECJ, concerning the interpretation of this clause. In *Salix*, a case referred in March 2008 by the German courts, the Court has been asked whether ‘significant distortions of competition’, within the meaning of the open clause, only exists where treatment of a body governed by public law as a non-taxable person would lead to significant distortions of competition to the detriment of competing private taxable persons, or also, where treatment of a body governed by public law as a non-taxable person would lead to significant distortions to its detriment.³⁵

Certain Activities or Transactions where not ‘Negligible’

Under the third paragraph of Article 13(1), where public sector bodies engage in the activities listed in Annex I to the CVSD, they will be regarded as taxable persons, unless such activities are carried out on a negligible scale.³⁶ Similarly to the main rule in the first paragraph of Article 13(1), the application of this exception appears to be dependent on the establishment of two cumulative elements: first, whether the activities at stake fall within the scope of those listed in Annex I; second, whether they are *not* being carried out on such a small scale as to be considered negligible. This, however, does not seem to be the Court’s understanding.

It is true that in *Câmara Municipal do Porto* the Court concluded that both elements had to be present in order for the exception to apply.³⁷ The question in that case however was whether the third subparagraph of Article 13(1) should be interpreted as meaning that bodies governed by public law are always regarded as taxable persons in respect of their non-negligible activities, or whether the criterion of the negligible scale of those activities applied only to the activities listed in Annex I. A different approach has been taken by the ECJ as regards the need to transpose

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³⁰ See n. 23 above, Opinion of the Advocate General, at paras 128 and 127, respectively.

³¹ Case C-8/01, *Assurandor-Societetet*, [2003] ECR I-13711.

³² See n. 30 above, Opinion of the Advocate General, at para. 130.

³³ Case C-288/07, *Isle of Wight and Others*, Judgment of 16 Sep. 2008, nyr, at para. 53.

³⁴ *Ibid.*, at paras 65 and 79.

³⁵ Case C-102/08, *Salix*, [2008] OJ C142/12.

³⁶ Annex I lists the following activities: telecommunications services; supply of water, gas, electricity and thermal energy; transport of goods; port and airport services; passenger transport; supply of new goods manufactured for sale; transactions in respect of agricultural products, carried out by agricultural intervention agencies pursuant to Regulations on the common organization of the market in those products; organization of trade fairs and exhibitions; warehousing; activities of commercial publicity bodies; activities of travel agents; running of staff shops, cooperatives and industrial canteens and similar institutions; and, activities carried out by radio and television bodies.

³⁷ See n. 22 above, at para. 28.

the non-negligible criterion. In *Carpareto Piacentino and Rivergaro*, the ECJ stated that:

Having regard to the structure of the provision in question, it must be interpreted as meaning that the Member States are free to exclude from the scope of such compulsory treatment the activities listed in [Annex I] in so far as they are carried out on a negligible scale, but are not required to do so. Consequently, they are also not required to fix a ceiling for treatment as non-taxable persons in respect of the activities at issue.³⁸

A similar approach was taken by the ECJ in *Commune di Carpaneto Piacento and Others*,³⁹ and by Advocate General Kokott in *T-Mobile and Others*.⁴⁰ Thus it seems that the essential element of the non-negligible clause is actually the first element – the activities at stake must fall within the scope of those listed in Annex I – whereas the transposition of the second element is optional. Perhaps as a result of this optionality, the Court has never ruled on the meaning of negligible for the purposes of that provision. On the contrary, as regards the first essential element, the Court has had a limited number of opportunities to rule on the interpretation of any of the activities listed in Annex I, all of which within the last few years. From the jurisprudence regarding the interpretation of the different activities listed in Annex I the following emerges:

- the expression ‘telecommunications’ in point 1, should be construed in its narrower sense and consequently, does not include the allocation by the State of frequency use rights to supply mobile communications services (Advocate General Kokott in *T-Mobile and Others* and *Hutchison 3G and Others*);⁴¹
- milk quotas sales points cannot be regarded either as a ‘transaction in respect of agricultural products’, within the meaning of point 7, or a ‘staff shop’, within the meaning of point 12 (*Gotz*);⁴²
- laying mains connections forms part of a supply of water, for the purposes of point 2 (*Zweckverband*).⁴³

Equally, it now seems settled case-law that in the absence of definitions of the activities listed in Annex I, the ECJ will take into account, when interpreting those provisions, not only their wording, but also the context in which they were approved and the objective pursued by

the rules,⁴⁴ that is, the Court will engage in both historical and teleological interpretations when considering the activities listed in Annex I.

Intra-Community Acquisitions above the Threshold

Article 2(1)(b)(i) of the CVSD read in conjunction with Article 3(1)(b), (2)(a) and (b), and (3) of the same Directive, mean that intra-Community acquisitions by public sector bodies will not be subject to VAT if they are below the EUR 10,000 threshold, unless the body opts otherwise. However, once that threshold is exceeded, or if it has been exceeded in the previous calendar year, all intra-Community acquisitions will be taxable. The ECJ has until now, never been called upon to interpret these provisions.

Exempt Activities Clause

Under Article 13(2) of the CVSD, where public sector bodies engage in exempt activities, listed in certain articles of the CVSD, as *not* being as public authorities, Member States may still regard them as falling under the scope of the main rule, and thus non-taxable for the purposes of those activities. This exception to the first paragraph of Article 13(1), extending its scope, is based on a complex inter-connection between this Article and provisions on exemptions. One of the questions it raises concerns the scope of the optionality granted therein to the Member States. This has been the subject of a recent reference to the ECJ. In *Salix*, the German courts have asked the Court whether Member States may treat activities of States, regional and local authorities and other bodies governed by public law, which are exempt, as activities in which they engage as public authorities, only where the Member States make express legal provision to that effect.⁴⁵

Although this exception to the main rule was already present in the original version of the Sixth VAT Directive, its wording has been changed slightly post-recast.⁴⁶ Under the original version, the then fourth paragraph of Article 4(5) referred exclusively to exempt activities under what are now Articles 132, 135, 136 and 371, 374 to 377, 378(2) and 379(2). Yet, the current provision refers to various other exemptions, which had not been previously set out within those Articles, but rather in the various Acts of

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³⁸ See n. 13 above, at para. 27.

³⁹ See n. 20 above, at para. 27.

⁴⁰ See n. 23 above, at para. 102.

⁴¹ See n. 23 above, Opinion of the Advocate General, at paras 84 et seq.

⁴² See n. 27 above, at para. 33.

⁴³ Case C-442/05, *Zweckverband*, Judgment of Apr. 2008, nyr, at para. 44.

⁴⁴ See n. 43 above, at para. 30 and n. 41 above, Opinion of the Advocate General, at paras 84 et seq.

⁴⁵ Case C-102/08, *Salix*, [2008] OJ C142/12.

⁴⁶ Sixth Council Directive 77/388/EEC of 12 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes – Common system of VAT: uniform basis of assessment, [1977] OJ L145/1.

Accession. This broadening of the scope of the exception should be seen in the context of previous jurisprudence on the matter.

In 1995 the ECJ was called upon to interpret Article 13(2), in its original version, in *Marktgemeinde Welden*,⁴⁷ a case concerning a German municipality engaging in the letting of immovable property. In essence, the question asked to the Court was whether exempt activities in respect of which it is possible to opt to be taxed, such as letting of immovable property, fell within the scope of Article 13(2), in particular where these activities are pursued under the same legal conditions, and in the same way, as private traders.

In a written submission to the Court, the Commission defended the adoption of a strict interpretation of Article 13(2). It argued that, as a provision derogating from the basic system introduced by the Directive, it should be strictly interpreted and thus applied to the activities exempted under Articles 132, 135 and 136 only insofar as they were expressly associated with bodies governed by public law. Activities, such as the letting of buildings, did not satisfy that criterion. The Court, however, disagreed. It considered that Article 13(2) did not distinguish between the several activities included in those Articles, and thus without further reasoning, concluded that:

Member States are authorised to exclude from treatment as taxable persons bodies governed by public law which carry out activities exempted under Article 13 of the directive, even if they are performed in a similar manner to those of a private trader.⁴⁸

This approach was reiterated by the ECJ a few years later, in *Câmara Municipal do Porto*.⁴⁹ However, even in the absence of the Court's case-law, a strict interpretation of Article 13(1), as suggested by the Commission in *Marktgemeinde Welden*, would in any event probably be contrary to the new wording of the provision. The legislator's reference, under the new wording, to various Articles which do not include any exemptions specifically directed at bodies governed by public law, is in itself a clear indication that the scope of the provision is not limited to those exemptions that do.

In light of the above, the fundamental question is therefore what are the legal implications of the clause in Article 13(2), in particular under its new wording? First, it clearly follows from that clause that Member States may, in principle, treat any of the exempt activities

listed as non-taxable, or outside the scope of VAT, where performed by bodies governed by public law. Arguably, however, this entitlement is subject to two restrictions: the clause will not apply where treating these activities as outside the scope of VAT gives rise to significant distortions of competition (Article 13(1), second paragraph); and where performance of exempt activities entails supply of goods or services listed in Annex I, these supplies will be taxable unless done on a negligible scale (Article 13(1), third paragraph). Although the ECJ has not yet ruled on the inter-connection between Article 13(2) and the other clauses in Article 13, this seems to be the most reasonable interpretation in light of the wording of those provisions.

Second, the exempt activities clause in Article 13(2), particularly in its new wording, will potentially result in further erosion of the tax base. It is true that, insofar as the tax base is concerned, it is irrelevant whether activities are exempt or outside the scope of VAT, as in both cases they will be excluded from the tax base. The rationale behind this clause seems to be that the activities falling within its scope would have been *prima facie* excluded from the tax base, on the basis of the exemptions' provisions; thus their treatment as outside the scope of VAT would have no additional effect on the tax base. This however rests on the assumption that all exemptions at stake will apply regardless of the identity of the supplier, something which, despite the Commission's recent remarks,⁵⁰ appears far from clear. On the one hand, as the Commission itself pointed out in *Marktgemeinde Welden*, differences in the wording of the exemptions seem to suggest that some are only applicable when supplied by a particular body. On the other hand, the principle of strict interpretation of exemptions, as developed by the ECJ, has resulted in some exemptions being, either *de jure*, or *de facto*, only applicable where the activities are undertaken by a specific type of supplier.⁵¹

Finally, the Court's rulings in *Marktgemeinde Welden* and *Câmara Municipal do Porto*, and the new wording of Article 13(2) post-recast, raise the question of whether the reference in various exemptions to 'bodies governed by public law' should be deemed redundant. If Member States can deem all exemptions to be outside the scope of VAT, regardless of the wording of the exemptions' provisions, then the references to 'bodies governed by public law' within some of those would seem to have little legal meaning. This will be true for the most part. However,

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⁴⁷ Case C-247/95, *Marktgemeinde Welden*, [1997] ECR I-779.

⁴⁸ *Ibid.*, at para. 20.

⁴⁹ See n. 22 above, at paras 40 to 46.

⁵⁰ See *Consultation Paper on Modernising Value Added Tax Obligations for Financial Services and Insurances* (2006), at 9.

⁵¹ For examples of the first type, see cases C-401/05, *VDP Dental Laboratory*, [2006] ECR I-12121, on the interpretation of the exemption applicable to dental services (Art. 132(1)(e) of the CVSD), and C-453/93, *W. Bultuis-Griffioen*, [1995] ECR I-2341, on the interpretation of the exemption applicable to welfare and social security work (Art. 132(1)(g) of the CVSD). For an example of the second type, see case C-472/03, *Arthur Andersen*, [2005] ECR I-1719, on the interpretation of the insurance exemption (Art. 135(1)(a) of the CVSD). On the case-law on insurance transactions, see also R. de la Feria, 'The EU VAT Treatment of Insurance and Financial Services (Again) under Review', *EC Tax Review* 2 (2007): 74-89.

there are two circumstances within which reference to ‘bodies governed by public law’ might remain relevant. As regards activities which fall within the scope of exemptions that *do not* refer specifically to public bodies, Member States may opt to deem those activities as outside the scope of VAT, but they would not have been necessarily regarded as exempt, under ECJ case-law. However, as regards activities which fall within the scope of exemptions that *do* refer specifically to public bodies, they will always be deemed exempt, thus removing the optionality element. In addition, where Member States avail of the option provided for in Article 13(2), classification of the activities as outside the scope of VAT will be subject to the exceptional clauses in the second and third paragraph of Article 13(1). Such control will not be present as regards exemptions: where activities undertaken by public bodies fall within the scope of one of the exemptions, they will be deemed exempt, regardless of whether exempting those activities gives rise to significant distortions of competition, or whether they include the supply of specific goods or services.⁵²

2.2. Public Sector Bodies: Exempt or Non-exempt

As clearly results from the above discussion, even where a public sector body is deemed to be a taxable person under Article 13 and Annex I to the CVSD, the activities / transactions in which they engage, although subject to VAT, might not necessarily be taxable. Having determined the taxable status of a particular public sector body, the second step in order to determine the VAT treatment of its activities is to establish whether those activities are listed in any of the exemptions’ provisions in the CVSD, in particular those listed in Article 132 therein. In this regard, the guidance provided by the ECJ is equally fundamental and can be divided into two components: jurisprudence

regarding the application of exemptions to public sector bodies, specifically; and case-law regarding the interpretation of exemptions in general.

2.2.1. Exemptions Applicable to the Activities of Public Sector Bodies

For the reasons set out above, it is unclear whether all exemptions could potentially apply to activities undertaken by public sector bodies, or merely the ones listed in Article 132, which refer specifically to the public nature of the supplier.⁵³ Unfortunately, there is no jurisprudential guidance on this matter.

Despite the vast case-law regarding exemptions,⁵⁴ hitherto the ECJ has never been asked whether specific activities of a public sector body should fall within the scope of any of the exemptions in the CVSD, which did not make reference to ‘public’ bodies in their wording. In fact, the number of ECJ cases concerning the interpretation of exemptions’ provisions and involving public sector bodies is, relatively speaking, small, with only five cases reported to date,⁵⁵ although further growth is envisaged.⁵⁶ In all of these cases the aim was to include certain activities within the scope of the exemptions: in one case, the activities of a public body itself were at stake;⁵⁷ in all others, the public activities concerned were undertaken by either an intermediary, or a subcontractor, on behalf of the public body. The Court’s initial approach to these situations, as reflected in *Commission v. Germany*, was to refuse the inclusion of the activities under consideration within the scope of the exemption, on the basis of a strict interpretation of the provisions.⁵⁸ In more recent cases, namely *Stichting Kinderopvang Enschede* and *Horizon College*, the Court has adopted a more nuanced approach, refusing *prima facie* the extension of the scope of the exemption, but allowing the exceptional inclusion of intermediary

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⁵² Except, of course, in two situations: first, where the exemption itself limits its own scope to situations which do not cause distortions of competition, as in the case of Art. 132(1)(f), or Art. 132(1)(l) of the CVSD, see the Court’s approach to the relevance of this limitation in case C-8/01, *Assurandor-Societetet*, [2003] ECR I-13711; second, where the Member States themselves impose the restriction that exemptions will not be granted where they will be likely to cause distortions of competition, under Art. 133(d) of the CVSD.

⁵³ These are: the supply by the public postal services (Art. 132(1)(a)); hospital and medical care and closely related activities undertaken by bodies governed by public law (Art. 132(1)(b)); the supply of services and of goods closely linked to welfare and social security work, including those supplied by old people’s homes, by bodies governed by public law (Art. 132(1)(g)); the supply of services and goods closely linked to the protection of children and young persons by bodies governed by public law (Art. 132(1)(h)); children’s or young people’s education, school or university education, vocational training or retraining, including the supply of services and goods closely related thereto, provided by bodies governed by public law (Art. 132(1)(i)); certain cultural services and goods closely linked thereto supplied by bodies governed by public law (Art. 132(1)(n)); and activities of public radio and television bodies other than those of commercial nature (Art. 132(1)(q)).

⁵⁴ For a comprehensive review of the ECJ case-law on exemptions, see R. Lares, *Apontamentos sobre a Jurisprudência Comunitária em Matéria de Isenções do IVA* (Lisboa: Almedina, 2006). One of the exemptions which has given rise to more case-law is the one applicable to medical services (Art. 132(1)(a)). For a comprehensive analysis of that case-law, including of many of the rulings mentioned in Section 2.2.2, see J. Swinkels, ‘VAT Exemption for Medical Care’, *International VAT Monitor* 1 (2006): 14–18; see also, G. Morse, ‘Separate or Composite Supplies for VAT: Assessing the Level of Generality: *Dr. Beynon and Partners v. Customs & Excise Commissioners*’, *British Tax Review* 2 (2005): 190–196.

⁵⁵ Cases 107/84, *Commission v. Germany*, [1985] ECR 2655, regarding the interpretation of the exemption applicable to postal services (Art. 132(1)(a)); C-287/00, *Commission v. Germany*, [2002] ECR I-5811, regarding the interpretation of the exemption applicable to education services (Art. 132(1)(i)); C-415/04, *Stichting Kinderopvang Enschede*, [2006] ECR I-1385, regarding the interpretation of the exemptions applicable to welfare and social security work, and protection of children (Art. 132(1)(g) and (h)); C-434/05, *Horizon College*, [2007] I-4793 and C-445/05, *Haderer*, [2007] I-4841, both regarding the interpretation of the exemption applicable to education services (Art. 132(1)(i)).

⁵⁶ See case C-357/07, *TNT Post UK*, [2007] OJ C247/12, regarding the interpretation of the exemption applicable to postal services (Art. 132(1)(a)).

⁵⁷ Case C-287/00, *Commission v. Germany*, [2002] ECR I-5811.

⁵⁸ Case 107/84, *Commission v. Germany*, [1985] ECR 2655.

or subcontracted services, when certain conditions were fulfilled, in particular:

- where the service is of such a nature or quality that it could not be assured of obtaining a service of the same value without the assistance of an intermediary or subcontracted service; and
- the basic purpose of the intermediary or subcontracted services is not to obtain additional income for the service provider by carrying out transactions which are in direct competition with those of commercial enterprises liable for VAT.⁵⁹

Various significant points emerge from these rulings. Firstly, it is clear, in light of the lack of jurisprudence relating to activities of public sector bodies in the context of exemptions not listed in Article 132, as well as the nature of the services listed in Article 132 as ‘exemptions applicable to certain activities in the public interest’, that regardless of the legal position adopted, in practice the assessment as to whether the activities of public bodies are, or are not, exempt, will in most cases be centred on the interpretation of the exemptions listed in Article 132 in general, and on those where the legislator already makes specific reference to the public nature of the supplier, in particular.⁶⁰ Secondly, it is equally clear that outsourcing or subcontracting of activities by public sector bodies is now common practice and that this practice gives rise to difficulties, in particular in terms of the interpretation of the exemptions’ provisions and the inherent limitation to the right to deduct any VAT charged.⁶¹ Third, it is interesting to note the increasing number of cases concerning the interpretation of exemptions in the context of cases involving public sector bodies: of the five cases signalled here, only one dates back to prior to the year 2002. This surge is likely to denote increased interpretative difficulties in light of new economic practices.⁶²

2.2.2. Interpretative Principles Applicable to All Exemptions

When assessing whether a specific activity undertaken by a public sector body is exempt or not, consideration should also be given to general interpretative principles developed by the Court and applicable to all exemptions. In particular, three principles are worth noting, namely the principle of strict interpretation of exemptions, the principle of contextual interpretation of exemptions, and the principle of uniform interpretation of exemptions.

The principle of strict interpretation is probably the one which is most often used by the Court when interpreting exemptions. In fact, the Court has consistently held that ‘the exemptions provided for in (Article 132, 135 and 136 of the CVSD) are to be interpreted strictly since they constitute exceptions to the general principle that turnover tax is to be levied on all services supplied for consideration by a taxable person’.⁶³ The Court’s preference for a strict interpretation of exemptions has manifested itself both as regards the services providers, and the type of services which may be exempt. Yet, it is important to note that the Court has sometimes departed from this strict interpretation,⁶⁴ in particular in more recent cases, often to ensure respect of the principle of fiscal neutrality and of its corollary, the principle of VAT uniformity, or of equal treatment, which precludes similar goods from being treated differently for VAT purposes.⁶⁵

On the application of the principle of contextual interpretation to exemptions, the Court has stated that ‘exemptions constitute independent concepts of Community law which must be placed in the general context of the common system of VAT introduced by the Sixth Directive’.⁶⁶ Thus, exemptions are to be interpreted not only by reference to the context and the purpose of the rules of which they form part, but equally taking into consideration the intention of the legislator at the time when the rules were introduced in 1977.⁶⁷

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⁵⁹ Cases C-415/04, *Stichting Kinderopvang Enschede*, [2006] ECR I-1385 and C-434/05, *Horizon College*, [2007] I-4793.

⁶⁰ This is, of course, not to say that situations could not be easily envisaged where activities of public sector bodies fell within the scope of other exemptions, see for example the exemption regarding activities concerning immovable property, Art. 135(1)(j),(k) and (l) of the CVSD.

⁶¹ On the legal and economic difficulties created by exemptions, see Section 3.

⁶² See also Section 3.

⁶³ Case C-453/93, *W. Bulthuis-Griffioen*, [1995] ECR I-2341, at para. 19. See also, for other cases where the Court adopted a strict interpretation of exemptions: case 253/85, *Commission v. United Kingdom*, [1988] ECR 817; case 122/87, *Commission v. Italy*, [1988] ECR 2685; C-212/01, *Unterperntinger*, [2003] ECR I-13859, all of which regarding the interpretation of the exemption applicable to medical services (Art. 132(1)(b)); C-149/97, *Institute of Motor Industry*, [1998] ECR I-7053, regarding the interpretation of the exemption applicable to trade unions (Art. 132(1)(l)); and C-150/99, *Stockholm Lindopark*, [2001] ECR I-493, on the interpretation of the exemption applicable to sport organizations (Art. 132(1)(m)).

⁶⁴ See, amongst others, cases C-76/99, *Commission v. France*, [2001] I-249; C-307/01, *d’Ambrunil*, [2003] ECR I-13989; and C-106/05, *L.u.p.*, [2006] ECR I-5123, all of which regarding the interpretation of the exemption applicable to medical services (Art. 132(1)(b)); C-216/97, *Gregg*, [1999] ECR I-4947, on the interpretation of the exemptions applicable to medical services and that applicable to welfare and social work (Art. 132(1)(b) and (g)); C-124/96, *Commission v. Spain*, [1998] ECR I-2501; C-174/00, *Krennemer Golf*, [2002] ECR I-3293, both on the interpretation of the exemption applicable to sport organizations; and C-144/00, *Hoffman*, [2003] ECR I-2921, regarding the interpretation of the exemption applicable to cultural services (Art. 132(1)(n)).

⁶⁵ As C. Amand points out, the recurrent struggle between the principles of strict interpretation and fiscal neutrality is highlighted in the Court’s rather distinct approaches to *W. Bulthuis-Griffioen* and *Gregg*, see ‘VAT for Public Entities and Charities – Should the Sixth Directive Be Renegotiated?’, *International VAT Monitor* 6 (2006): 433-443, at 437.

⁶⁶ C-141/00, *Kluger*, [2002] ECR I-6833, on the interpretation of the exemptions applicable to medical services and that applicable to welfare and social work (Art. 132(1)(b) and (g)). See also C-384/98, *D.*, [2000] ECR I-6795, regarding the interpretation of the exemption applicable to medical services (Art. 132(1)(b)).

⁶⁷ See n. 50 above, at 10.

Finally, as regards the uniform interpretation of exemptions, the ECJ has stated that ‘exemptions constitute independent concepts of Community law whose purpose is to avoid divergences in the application of the VAT system from one Member State to another’.⁶⁸ Yet, as with the principle of strict interpretation, it is noteworthy, than on occasion the Court has adopted a more nuanced approach to the principle of uniform interpretation. In the recent *Solleveld* ruling the Court stated that Article 132(1)(c) of the CVSD must be interpreted as conferring on Member States ‘the discretion to define the paramedical professions and the medical care coming within the scope of such professions for the purpose of the exemption laid down by that provision’, so long as, in the exercise of that discretion, Member States ‘comply with the objective pursued by the said provision [...] and the principle of fiscal neutrality’.⁶⁹

It follows from the above that, in addition to the three interpretative principles already highlighted, when interpreting exemptions the Court often makes reference to the general VAT principle of fiscal neutrality. The Commission has even gone so far as to state that the rule according to which ‘the interpretation [of exemptions] must meet the requirements of the principle of fiscal neutrality on which the entire systems of VAT is based’, is one of only three ECJ jurisprudential pillars on exemptions.⁷⁰ Whilst this is certainly true,⁷¹ it is equally worth noting that the Court itself has limited the applicability of the principle of fiscal neutrality, insofar as the insurance services exemption is concerned.⁷² This is because, as discussed below, the existence of exemptions is itself a contravention of the principle of fiscal neutrality.⁷³

The following diagram is an attempt at summarizing the current VAT treatment of public sector bodies, as described above.

3. LEGAL AND ECONOMIC CONSEQUENCES OF THE CURRENT EU VAT TREATMENT OF PUBLIC SECTOR BODIES

The current VAT treatment of public sector bodies gives rise to serious consequences, at both legal and economic levels.⁷⁴ From a legal perspective the current regime gives

rise to definitional and interpretative problems, creates difficulties in calculating the portion of deductible VAT, constitutes an incentive to engage in aggressive tax planning, and has the additional problem of being conceptual incoherent with the general principles of the EU VAT system. From an economic perspective, the restrictions to the deduction of input tax, which are the consequence of the current regime, have also resulted in considerable distortions. In addition, there is no definite economic evidence that exclusion of the products supplied by public sector bodies from full taxation, achieves the social and distributional aims that are often pointed out as the main reason for their current EU treatment.

3.1. Legal Consequences

Definitional and Interpretative Problems

As the above case-law analysis demonstrates, the legal provisions determining the current VAT treatment of public sector bodies, in particular Articles 13 and 132 and Annex I to the CVSD, are unclear and thus susceptible to differing interpretations and applications. In the last thirty years the ECJ has struggled with the meaning of expressions such as ‘engaged in as public authorities’ (Article 13(1), first paragraph), ‘significant distortions to competition’ (Article 13(1), second paragraph), and with the determination of the scope of exemptions (Article 132(1)). Yet, the steady increase in references from national courts to the ECJ, focusing on the interpretation of these provisions, is significant, and is also symptomatic of two facts. First, it reflects the outdated nature of the existing provisions. These are unable to deal with a new economic environment, where competition between public and private bodies is common occurrence,⁷⁵ and the pressure to increase efficiency in the provision of public services has witnessed increased resort to subcontracting and outsourcing. Second, it relays the Court’s inability, despite its thirty year struggle, to resolve the inherent problems of the existing VAT treatment of public sector bodies’ activities, leading to a climate of legal uncertainty whereby, both these bodies and tax administrations alike,

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⁶⁸ Joint cases C-394/04 and C-395/04, *Ygeia*, [2005] ECR I-10373, regarding the interpretation of the exemption applicable to medical services (Art. 132(1)(b)), at para. 15. See also cases 348/87, *Stichting Uitvoering Financiële Acties*, [1989] ECR 1737, on the interpretation of the exemption applicable to independent groups of people (Art. 132(1)(f)); and C-498/03, *Kingscrest Associates and Montecello*, [2005] ECR I-4427, regarding the interpretation of the exemption applicable to welfare and social work (Art. 132(1)(g)).

⁶⁹ Case C-443/04, *Solleveld*, [2006] ECR I-3617, at para. 51.

⁷⁰ See n. 50 above, at 10.

⁷¹ See cases C-216/97, *Gregg*, [1999] ECR I-4947, at para. 19; C-141/00, *Kluger*, [2002] ECR I-6833, at para. 29; and C-45/01, *Dornier*, [2003] ECR I-12911, the interpretation of the exemption applicable to medical services (Art. 132(1)(b)), at para. 42.

⁷² Case C-8/01, *Assurandor-Societetet*, [2003] ECR I-13711, at para. 75.

⁷³ See Section 3.1.

⁷⁴ Many of these difficulties are common to those faced by charities and other non-governmental organizations, see J. Warburton, ‘Charities and Business: A VAT Conundrum’, *British Tax Review* 1 (2007): 73 et seq.

⁷⁵ See S.D. Coleclough, ‘The Sixth VAT Directive and the Need for Reform’, *British Tax Review* 4 (1995): 378-384, at 380.



are increasingly unsure as to whether a specific activity is outside the scope of VAT, is exempt, or is taxable.⁷⁶ This uncertainty in turn had the effect of increasing compliance and administrative costs, as more time and resources will be devoted to establishing the correct VAT treatment of each activity undertaken by that public sector body.

Calculation of Recoverable Input VAT and Apportionment of Tax

One of the most obvious legal consequences of the existing VAT treatment of public sector bodies is the fact that it gives rise to apportionment of input tax situations. Fully outside the scope, or exempt, public bodies are probably a rarity. More common will be the situation whereby one particular body has a mixed VAT nature, engaging in activities which are at the same time outside the scope, exempt, and taxable. This means in practice that most bodies will be able to deduct at least part of their input VAT, under Articles 173 to 175 of the CVSD. The difficulties reside in the fact that calculation of deductible VAT, as prescribed in those provisions, is itself problematic, and has given rise to considerable case-law.⁷⁷

Although a comprehensive analysis of the different methods of apportioning input VAT is outside the scope of this article, it is worth noting that there are essentially two methods of determining the proportion of deductible input VAT, namely direct allocation and pro-rata. Member States can use either of these methods, or a combination of both, and in this respect they display significant discrepancies.⁷⁸ However, whichever the preferred method, the process tends to be complex, as with the definitional and interpretative problems highlighted above, thereby entailing high administrative and compliance costs. As the Commission itself has recently acknowledged:

This process generates considerable administrative charges for economic operators and fiscal authorities and is a continuous source of litigation, creating an atmosphere which reduces the level of legal certainty for businesses and increases budgetary insecurity for Member States.⁷⁹

Planning and Aggressive Planning

For any partially exempt or non-taxable legal person, faced with the reality of non-deductibility of all their input VAT, there are two basic methods of curtailing VAT costs: minimizing VAT input, by acquiring less goods and/or services, which are subject to VAT; and maximizing VAT output, by increasing the number of taxable supplies and, thus, the overall percentage of deductible input VAT. Whilst the legitimacy of engaging in VAT planning has been acknowledged by the ECJ in joint cases *Gemeente Leusden and Holin Groep*,⁸⁰ non-tax reasons will often prevent legal persons from adopting measures, which will reflect either of these methods. It is in this context that so-called aggressive VAT planning, or VAT avoidance, schemes, will often emerge.⁸¹ In fact, two recent cases, *University of Huddersfield* and *Centralan*, have demonstrated how VAT costs, resulting from the exclusion of the right to deduct input tax, can act as a catalyst for public bodies in general, and universities in particular, to engage in aggressive VAT planning.⁸²

Conceptual Incoherences

From a conceptual perspective, the current VAT treatment of public sector bodies is also defective. By treating these bodies as de facto final consumers, in respect of many of their activities, the current regime is arguably contrary to the principle of VAT as a tax on consumption,⁸³ which constitutes one of the fundamental principles of the EU VAT system.⁸⁴ Not only should final consumers be, by nature, physical persons,⁸⁵ but equally the treatment as final consumers of public bodies does not accurately reflect practice, as goods and services supplied to those bodies will unavoidably be used as inputs to the activities, in which they are engaged. Furthermore, the current regime applicable to public sector bodies inherently contravenes the principle of fiscal neutrality, as set out in Article 1 of the CVSD and developed by the ECJ – another fundamental principle of the EU VAT system. As Advocate General Jacobs so clearly stated in *Waterschap*

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⁷⁶ This climate of legal uncertainty resulting from the case-law is also reflected in Member States' discrepant transposition of the provisions in Art. 13 of the CVSD into domestic legislation, see interesting account provided by O. Jimenez, 'VAT and Public Bodies in EC Member States', *Intertax* 36, nos 6/7 (2008): 268-281.

⁷⁷ See in particular landmark case C-98/98, *Midland Bank*, [2000] ECR I-4177.

⁷⁸ See general overview provided by C. Amand, n. 65 above, at 434. See also, H. Huzinga, 'Financial Services VAT – VAT in Europe?', *Economic Policy* October (2002): 499-534, at 501.

⁷⁹ See n. 50 above, at 7.

⁸⁰ Joint cases C-487/01 *Gemeente Leusden*, and C-7/02, *Holin Groep*, [2004] ECR I-5337.

⁸¹ For an analysis of the meaning and catalysts for aggressive VAT planning, see R. de la Feria, 'The European Court of Justice's Solution to Aggressive VAT Planning – Further towards Legal Uncertainty?', *EC Tax Review* 1 (2006): 27-35.

⁸² Cases C-223/03, *University of Huddersfield*, [2006] ECR I-1751 and C-63/04, *Centralan*, [2005] ECR I-11087, respectively.

⁸³ P. Gottfried & W. Wiegard go so far as to state that 'contrary to common belief, VAT no longer equals a consumption tax when exemptions are granted', in 'Exemption versus Zero-Rating – A Hidden Problem of VAT', *Journal of Public Economics* 46, no. 3 (1991): 307-328, at 308.

⁸⁴ See D. Butler, 'VAT as a Tax on Consumption: Some Thoughts on the Recent Judgement in *Parker Hale Ltd v. Customs and Excise Commissioners*', *British Tax Review* 5 (2000): 545-553.

⁸⁵ As highlighted by M. Aujean et al., n. 2 above, at 145.

Zeeuws Vlaanderen, a case concerning the right to deduct of public sector bodies:

It is inherent in the existence of exceptions to the VAT system that they will interfere to some extent with the application of the principles of neutrality and of equality treatment. Whatever the merits of the decision to treat public sector bodies as final consumers, it forms an integral part of the Directive. In that in comparable situations, the treatment of taxable persons and persons excluded from the VAT system will inevitably be different.⁸⁶

3.2. Economic Consequences

Tax Cascading

One of the main side effects of treating activities as outside the scope of VAT or exempt, and the consequent non-deductibility of related input VAT, is the possibility of tax cascading.⁸⁷ Tax cascading will occur where the service supplied by the public sector body is an intermediate step in the production, and therefore, the VAT levied until then becomes a hidden cost (as it cannot be deducted). The higher the VAT rate applicable to input supplies, the potentially higher the amount of hidden VAT included in the supplies of services by public bodies. Moreover, according to economic commentators, this is especially true in the case of public services.⁸⁸ This is all the more important when considering that avoiding tax cascading effects is, not only one of the main principles of commodity taxation,⁸⁹ but equally one of the principal reasons behind the introduction of the EU VAT system.⁹⁰

Erosion of VAT Base/Break of VAT Chain

Connected to the problem of tax cascading is another negative consequence of the current EU VAT treatment of public sector bodies. Whilst, it is widely accepted within the economic literature that VAT efficiency levels are directly related to its taxable base,⁹¹ the current regime erodes the VAT base and breaks the VAT chain. Moreover, some authors have drawn attention to the

phenomenon of 'creeping exemptions'. They contest that, as more exemptions are granted, other sectors of the economy will be tempted to claim exemptions for themselves thus further eroding the tax base.⁹² As regards the activities of public sector bodies, this phenomenon is particular evident in the recent ECJ case-law concerning intermediary and sub-contracted services.⁹³

Self-supplies versus Outsourcing: Bias Away from Outsourcing

Another important consequence of the current VAT treatment of public sector bodies is the fact that it encourages self-supplies. The reason is clear: in the case of self-supplies, the public bodies will only have to pay VAT on the purchase of goods or services involved; on the contrary, where there is outsourcing or subcontracting of services to a private entity, VAT will be charged on the full price of those services. As the right to deduct input VAT of public bodies is limited, VAT charged on outsourced or subcontracted activities will represent an extra cost, whilst, where there is a self-supply this extra cost will be avoided. This bias is all the more serious when considering that recent economic literature indicates that contracting out government services is economically more efficient and saves taxpayers' money, with some commentators suggesting as much as 20% savings. Although many have focused particularly on refuse collection,⁹⁴ some economic studies indicate that the private sector is found to be more efficient in other areas, such as fire protection, cleaning services and waste-water treatment.⁹⁵

Lack of Effect on Regressivity of VAT

As highlighted above, there is a perception that exclusion of the products supplied by public sector bodies from full taxation, achieves social and distributional aims by increasing consumption of so-called merit goods, and diminishing the natural regressivity of VAT. Yet, the effectiveness of this tactic is far from clear. Firstly, in order to achieve both these aims the exclusion from the tax base must be reflected in consumer prices, and it is not obvious whether this is actually the case. In fact, recent experiments with VAT rates seem to indicate that the opposite

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⁸⁶ Case C-378/02, *Waterschap Zeeuws Vlaanderen*, [2005] ECR I-4685, at para. 38.

⁸⁷ Also known as 'multiple taxation', see G. De Wit, 'The European VAT Experience', *Tax Notes International* 10, no. 2 (1995): 49-54.

⁸⁸ See economic analysis by P. Gottfried & W. Wiegard, n. 82 above, at 323.

⁸⁹ See E.H. Davis & J.A. Kay, 'Extending the VAT Base: Problems and Possibilities', *Fiscal Studies* 6, no. 1 (1985): 1-16, at 4.

⁹⁰ See *The EEC Reports on Tax Harmonisation – The Report of the Fiscal and Financial Committee and the Report of the Sub-Groups A, B and C* (Amsterdam: IBFD Publications, 1963).

⁹¹ See S. Cnossen, 'Is the VAT's Sixth Directive Becoming an Anachronism?', *European Taxation* 12 (2003): 434-442, at 435.

⁹² See A.A. Tait, *Value Added Tax – International Practice and Problems* (Washington DC: International Monetary Fund, 1988), 50.

⁹³ See Section 2.2.1.

⁹⁴ See E. Dijkgraaf & R.H.J.M. Gradus, 'Cost Savings of Contracting Out Refuse Collection', *Empirica* 30 (2003): 149-161.

⁹⁵ For a detailed overview of these studies see M.C. Wassenaar & R.H.J.M. Gradus, 'Contracting Out: The Importance of a Solution for the VAT Distortion', *CESifo Economic Studies* 50, no. 2 (2004): 377-396.

is true.⁹⁶ Secondly, it is widely accepted by economic commentators that indirect taxes are not an effective means of pursuing distributional goals, and it is far more efficient to tax as broadly as possible, using the yield to compensate low-income house-holds.⁹⁷

Finally, two additional points regarding the economic effects of the current EU VAT treatment of public sector bodies. First, in light of the all-time goal of the efficient allocation of resources by Governments, it is worth noting that all the difficulties highlighted here place extra costs and economic inefficiencies upon bodies, which are by nature funded by the taxpayer. Moreover, these costs should be put in the context of budgetary restraints – including, but not exclusively those resulting from the Economic and Monetary Union and the Stability and Growth Pact – which should imply not only cutting fiscal spending, but equally levying taxes more efficiently.⁹⁸ Secondly, it is also important to note that some of the problems highlighted here, which arise from the VAT treatment of public sector bodies, apply equally in relation to the private bodies benefiting from the same exemptions, such as charities and other non-governmental organizations. Moreover, the application of exemptions to private bodies may give rise to additional problems, such as significant loss of revenue.⁹⁹

4. ALTERNATIVE SOLUTIONS

Although in most countries the activities and transactions undertaken by public sector bodies are *prima facie* treated as VAT exempt or outside the scope of VAT, there are some notable exceptions, namely Canada, Australia and New Zealand. Canada applies a modified exemption system, whilst Australia and New Zealand fully tax most of the activities undertaken by public bodies, with some exceptions.

4.1. Refund Schemes

The regime applied in Canada is, in its essence, an exemption system: most public sector bodies' activities are exempt, although some may be taxable, or zero-rated; input VAT related to exempt activities will not be deductible. However, the Canadian VAT system departs from the traditional systems by granting a rebate of that input tax. The rebate scheme constitutes a feature of the Canadian system since its inception, in recognition of the difficulties arising from exemptions, in particular the bias towards self-supply; compliance costs are said to be average, whilst revenue effects are negative.¹⁰⁰ In Europe, similar schemes sometimes apply, but at the national, rather than the European, level.

In fact, with a view to counteracting the bias towards self-supplies and away from outsourcing, some Member States, namely Denmark, Finland, Sweden, the Netherlands and the United Kingdom, have opted for financing the VAT costs of public sector bodies through the introduction of a refund mechanism. Usually operating outside the VAT regime,¹⁰¹ these refund or compensation schemes aim to create a level playing field between self-supply of services and outsourcing.¹⁰² Whilst they vary considerably, the refund schemes generally apply to local governments, but VAT compensation may also operate at the level of central government.¹⁰³

The question is, therefore, whether the current EU VAT treatment of public sector bodies should be modified to include a refund scheme, similar to that applied in Canada, which would consequently be applicable in all Member States. Overall, studies seem to indicate that in general these schemes are having an impact on public sector bodies' choices, with the level of outsourcing of governmental activities increasing in Member States where refund schemes apply.¹⁰⁴ However, despite their

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⁹⁶ In particular the so-called 'labour-intensive experiment', implemented in 1999, and whose aim was to test the impact of reduced rates of VAT on job creation. In 2003, a report from the Commission confirmed that the impact of the introduction of reduced rates of VAT on prices was minimal: when conducting price surveys, Member States found that reduced rates of VAT were reflected in consumer prices only partially or not at all and that at least part of the VAT reduction was used to increase the margins of service providers; where the VAT reduction had been passed on to the consumer Member States found that this was only a temporary measure and prices would subsequently increase – see *Experimental Application of a Reduced Rate of VAT to Certain Labour-Intensive Services*, Report from the Commission to the Council and to the European Parliament, COM(2003) 309 final, 2 Jun. 2003.

⁹⁷ See A.A. Tait, n. 91 above, at 218. See also C.L. Ballard & J.B. Shoven, 'The Value-Added-Tax: The Efficiency Cost of Achieving Progressivity by Using Exemptions', in *Modern Development in Public Finance: Essays in Honor of Arnold Harberger*, ed. M.J. Boskin (Oxford: B. Blackwell, 1987), 109-129; and E.H. Davis & J.A. Kay, who provide amusing examples, illustrating the shortcomings of using the VAT structure as a mean to diminish its regressivity, n. 88 above, at 11-12.

⁹⁸ See B. Genser & P. Winker, 'Measuring the Fiscal Revenue Loss of VAT Exemption in Commercial Banking', *FinanzArchiv* 54, no. 4 (1997): 563-585, at 563.

⁹⁹ Whether or not public sector bodies are taxable is rather irrelevant from a strictly revenue point of view, as the payments on one side of the account will be balanced by collections on the other side, thus it can be said that it is merely a bookkeeping operation. However, the loss of revenue in relation to private sector bodies might be extremely relevant, see R. de la Feria, n. 51 above, at 76-78.

¹⁰⁰ For a detailed analysis of the Canadian system, see P.P. Gendron, n. 3 above, at 518-520.

¹⁰¹ Although, reportedly not in Finland, where the provisions allowing for VAT compensation are included within the VAT legislation, see X. Yang, 'VAT Treatment of Government Procurement: A Comparative Analysis', *International VAT Monitor* 5 (2005): 342-348, at 346.

¹⁰² Although no connection has been directly established between tax cascading and the introduction of VAT refund schemes, presumably these schemes would also have the side effect of preventing any cascading. The rationale for introduction of such schemes has however been heavily criticized, see W. van der Corput, 'Hollow-Sounding Arguments', *International VAT Monitor* 2 (2005): 92-93.

¹⁰³ Generally a global distinction can be made between open and closed models; for a more detailed view of the several types of refund schemes applied see M.C. Wassenaar & R.H.J.M. Gradus, n. 94 above, and H. van Dijk & G. Lubbers, 'The VAT Compensation Fun(d)?', *International VAT Monitor* 1 (2000): 6-9.

¹⁰⁴ See M.C. Wassenaar & R.H.J.M. Gradus, n. 94 above, at Tables 1 and 2. However, the effectiveness of Dutch scheme has been recently placed into question, see M.C. Wassenaar, E. Dijkgraaf & R.H.J.M. Gradus, 'Contracting Out: Dutch Municipalities Reject the Solution for the VAT-Distortion', *Free University Amsterdam, Faculty of Economics, Business Administration and Econometrics, Series Research Memoranda No. 3*, 2007.

potential advantages these schemes also give rise to difficulties, as follows:

- *Inclusion or exclusion of non-national VAT* – only in the Netherlands is refund given for non-national costs; this creates inequality between national and non-national suppliers, as the level playing field is only achieved in relation to national suppliers.
- *Inclusion or exclusion of exempt activities* – in the Netherlands and the United Kingdom, the refund is only given for VAT costs relating to outside the scope activities, whilst in Denmark, Finland and Sweden the refund also applies in relation to exempt activities. Both options have disadvantages: excluding exempt activities from the refund scheme signifies that in relation to these activities VAT considerations will continue to influence the choice between self-supplies and outsourcing; on the other hand, the inclusion of exempt activities within the scope of the scheme will lead to an unequal treatment between private and public suppliers, as most exemptions will also apply to private suppliers.¹⁰⁵
- *Inequality amongst Member States* – the existence of these schemes in only some of the Member States creates inequality within the Community. Although public sector bodies of different Member States will typically not be in direct competition, the private enterprises offering outsourcing governmental services might be. In this context private companies established in Member States, which have a refund scheme in place, will be at a competitive advantage to private companies established in Member States, which do not have such a scheme.

These special compensation schemes have traditionally been regarded as a purely financial operation and budgetary expenditure. As such, the Commission has so far considered them as falling outside the scope of the EU VAT system.¹⁰⁶ Yet, consideration should be given to the recent ECJ jurisprudence, namely *Heiser*,¹⁰⁷ which indicates the Court's willingness to extend the principles it has developed as regards state aid to the field of VAT.¹⁰⁸ In light of

the above, and in particular taking into account potential distortive effects to intra-Community trade amongst private enterprises offering outsourcing governmental services, it is conceivable that the Court would regard these schemes as illegitimate state aid, in contravention of Article 87 of the EC Treaty.

Of course, most of the distortions mentioned above could disappear if a refund scheme were to be introduced at EU level, thus allowing for a set of harmonized rules to dictate compensation to public sector bodies for irrecoverable input VAT. Would adopting such a scheme constitute the best way forward? Firstly, it is worth noting that the introduction of a refund scheme applicable to public sector bodies, but not to exempt private sector traders, would have the potential to give rise to significant distortions of competition at the internal level (rather than at intra-Community level, as highlighted above). Second, such a measure would constitute a significant departure from the fundamental principles of the EU VAT system, as set out in the CVSD and developed by the ECJ, in particular the principle of the right to deduct. Finally, the introduction of this type of schemes would add yet another layer of complexity, to an already immensely convoluted regime.¹⁰⁹

4.2. Full Taxation

The Australian and New Zealander GST systems, commonly designated as modern VAT systems, are essentially an attempt at (almost) full taxation.¹¹⁰ In both countries all activities of public bodies are within the scope of VAT and are, in principle, fully taxable. Under Australian GST rules a few exceptions apply: certain activities, where undertaken by specific bodies, such as government schools, will be regarded as zero-rated; and, certain entities can also opt to be exempt. The New Zealander system is not subject to these general exceptions and thus, considering its system of almost-full taxation of public activities, it is perhaps unsurprising that the New Zealander system has been hailed as an exemplary model insofar as the VAT treatment of these activities is concerned.¹¹¹ Common distortions, such as those found under the EU

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¹⁰⁵ Norway operates a similar scheme for non-profit organizations, see O. Gjems-Onstad, 'Refund of Input VAT to Norwegian NPOS', *International VAT Monitor* 4 (2004): 244-246.

¹⁰⁶ The compatibility of these refund schemes with the CVSD has been subject of a Parliamentary Question; former Commissioner Bolkestein replied on behalf of the Commission that such schemes do not conflict with the EU VAT system, see *Common VAT System – Eighth Directive*, Written Question P-2861/99, 7 Jan. 2000, [2000] OJ C225E/211.

¹⁰⁷ Case C-172/03, *Heiser*, [2005] ECR I-1627, concerning Austria's transposition of the exemption applicable to medical services (Art. 132(1)(c) of the CVSD).

¹⁰⁸ See J. Swinkels, 'State aid and VAT', *International VAT Monitor* 5 (2005): 311-316.

¹⁰⁹ In this regard, it is worthy of notice that the introduction of a VAT compensation scheme in the Netherlands did not have the broad welcome from local authorities that might have been expected, with one of the reasons pointed out being the excessive administrative costs it gives rise to, see M.C. Wassenaar, E. Dijkgraaf & R.H.J.M. Gradus, n. 103 above, at 12-13.

¹¹⁰ As opposed to 'traditional VAT systems', namely those based upon the European model, see R. Krever, n. 6 above, at 13 et seq.

¹¹¹ See R. Bird & P.P. Gendron, n. 1 above, at 95-97; A. Schenk & O. Oldman, n. 1 above, at 289-290; A.A. Tait, n. 91 above, at 78. This is also reflected on levels of efficiency, as recent studies carried out by the OECD indicate that New Zealander GST not only possesses by far the highest efficiency levels of all OECD countries, but equally levels which are over double those witnessed in some European countries, including the United Kingdom, see D. Snell, 'GST – Revenue and Business Risk', in *GST in Retrospect and Prospect*, eds R. Krever & D. White (Wellington: Thomson Brokers, 2007), 423-430, at 426.

VAT system, have been eliminated, without an increase of administrative and compliance costs, or a decrease in revenue.¹¹² Despite a few conceptual difficulties, namely regarding the calculation of the taxable amount in respect of certain activities such as subsidies and grants, full taxation offers many advantages and virtually no disadvantages (apart from potentially political ones).¹¹³ It is therefore disappointing that the EU VAT system seems further away from full taxation now, than when it was when first implemented thirty years ago.

5. MOVING IN THE WRONG DIRECTION: POLITICAL STAGNATION AND LEGAL EXTENSION OF CURRENT REGIME

The above alternatives to the current EU VAT treatment of public sector bodies are not without difficulties. Although, for the reasons highlighted above, full taxation appears to be the better of the two, arguably either would constitute an improvement to the status quo. Moreover, other less dramatic amendments to the current regime have recently been suggested.¹¹⁴ Ultimately, apart from political considerations, there appears to be no good reason, either, conceptual, administrative or budgetary, to maintain the current regime. Yet, there appears to be no significant progress, and if anything, reform of the current regime seems more distant now, than it did only a few years previously. Furthermore, recent jurisprudential and legislative developments seem to be pointing in the opposite direction, towards a deepening, rather than an elimination, of current legal and economic distortions.

5.1. Political Stagnation: Postal Services Proposal and Other Abandoned Initiatives

In 2003, the Commission put forward a proposal to amend the VAT treatment of the postal services, by eliminating the current exemption applicable to these services, under

Article 132(1)(a) of the CVSD, and thus making them taxable.¹¹⁵ However, the proposal was the target of criticisms by the European Parliament.¹¹⁶ Further to the Opinion of the European Parliament the Commission decided to present an amended proposal,¹¹⁷ which included the possibility of applying reduced rates of VAT to postal services, in order to avoid or to limit the price increases to a minimum. Yet, despite these amendments the discussions in the Council proved slow, with some Member States appearing to strongly oppose it. On 7 January 2004, during the Prime Minister questions and answers' session in the Parliament, the then UK Prime Minister, Tony Blair, confirmed that his government would continue to oppose any movement away from VAT exemption for postal services. Similarly, in Ireland, the move has not been without controversy, as demonstrated by the number of written questions addressed by Irish members of the European Parliament to the Commission on the contents and consequences of the proposal.¹¹⁸ Four years since the presentation of the amended proposal, it seems clear that its approval is now unlikely.

Meantime, early indications that reform of the current EU VAT regime applicable to public sector bodies was to be expected in the near future have not been fulfilled. In 2000, the Commission published a VAT strategy, aimed at improving the operation of the Internal Market. Under the heading 'other potential future priorities', the Commission set out the areas, which it considered, warranted a thorough review. The first item on this list was the treatment of subsidies, public authorities and services in the public interest:

Increasing privatisation of activities which were traditionally the exclusive reserve of the public sector has led to greater distortions of competition between exempt, non-taxable and taxable services. The VAT system for such services needs to be modernised taking into account of all interests involved [...] Exemptions without the right to deduction for social, educational, cultural and other activities also need to be reviewed to see whether they meet current needs.¹¹⁹

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¹¹² As P. Barrand comments: 'there are four arguments in particular which supported the proposed method of taxing government departments and local authorities in New Zealand. These are administrative simplicity, accountability and transparency of government operations, comprehensiveness of GST coverage and sound economic management', in 'The Taxation of Non-profit Bodies and Government Entities under the New Zealand GST', *International VAT Monitor* 1 (1991): 1-19, at 2-3.

¹¹³ See M. Aujean et al., n. 2 above, at 149; S. Poddar, 'Application of VAT to Public Bodies', Paper presented at *International Tax Dialogue VAT Conference*, Rome, 15-16 Mar. 2005, available at: <www.itdweb.org/VATConference/Pages/PapersPresentations.aspx>; P.P. Gendron, n. 3 above, at 521-522.

¹¹⁴ See M. Aujean, 'Application of VAT to Public Bodies: The EU VAT System, Current Issues and Proposals', in *VAT in Africa*, ed. R. Krever (Pretoria: Pretoria University Press, 2008), 71-79, at 77-79.

¹¹⁵ See Proposal for a Council Directive Amending Directive 77/388/EEC as regards VAT on services provided in the postal services, COM(2003) 234 final, 5 May 2003.

¹¹⁶ See Report on the proposal for a Council Directive amending Directive 77/388/EEC as regards VAT on services provided in the postal sector (COM(2003) 234 – C5-0227/2003 – 2003/0091(CNS)), A5-0122/2004, 11/03/2004.

¹¹⁷ Amended Proposal for a Council Directive amending Directive 77/388/EEC as regards Value Added Tax on services provided in the postal sector, COM(2004) 468 final, 8 Jul. 2004.

¹¹⁸ There has been a total of four written questions, as follows: VAT on postal services, Written Question E-1667/03 by Proinsias De Rossa (PSE) to the Commission, 19 May 2003, [2004] OJ C783E/34; Exemption from VAT on postage for charities, Written Question E-2400/03 by Avril Doyle (PPE-DE) to the Commission, 10 Jul. 2003, [2004] OJ C65E/142; Consultation with charities with regard to the proposal relating to the imposition of VAT on postal services, Written Question E-3631/03, by Proinsias De Rossa (PSE) to the Commission, 5 Dec. 2003, [2004] OJ C78E/617; and VAT on postal services, Written Question E-0922/04 by Proinsias De Rossa (PSE) to the Commission, 16 Mar. 2004, [2004] OJ C88E/551.

¹¹⁹ See n. 9 above, at 11.

The Commission's intention to reform the VAT treatment of public bodies was again reiterated in 2003, in their review and update of the VAT strategy. It stated then that preparatory work for reform of this area was already under way, and despite its complexity, a final proposal would be presented in the fourth quarter of 2004.¹²⁰ Yet, four years on from that date, the Commission has not only failed to do so, but equally there are no obvious signs of an intention to initiate the consultation process, which would usually precede such a move.¹²¹ This sequence of events raises the obvious question: why does there seem to have been an abandonment of the intention to reform the VAT treatment of public services? Most of the other items listed in the Commission's review of the VAT strategy seem to have indeed been the subject of a legislative proposal, albeit in many cases a belated one.¹²² It is, of course, impossible to answer with any level of certainty, but the suspicion is that Member States' reaction to the postal services proposal might have given the Commission an inkling as to the political sensitivities involving the public services area.

5.2. Legal Extension of Scope of Current Regime: Jurisprudential and Legislative Developments

As the case-law analysis undertaken above demonstrates, traditionally the approach adopted by the ECJ to the special regime applicable to public sector bodies, under the CVSD, has been to restrain the scope of its application, by giving preference to a strict interpretation of both Article 13 and the exemptions' provisions, particularly those in Article 132. Yet, there are signs of a departure from this traditional approach, with the Court increasingly delivering rulings which give preference to non-strict interpretations of those provisions, in light of the principles of fiscal neutrality, and its corollary, the principle of principle of VAT uniformity, or equal treatment.

Whilst conceptually, this is *prima facie* a more coherent position, it does give rise to some difficulties. Firstly, from a conceptual perspective, it is important to remember

that the Court itself has recognized that the regime currently applicable to public sector bodies is inherently in contravention of fiscal neutrality.¹²³ Thus, applying the principle of fiscal neutrality in a somewhat segmented manner to a specific set of circumstances, on a case-by-case basis, might not necessarily result in the increased neutrality which the Court is aiming for. In a field such as taxation, weighing of economic considerations is fundamental, yet a simplistic approach to economic matters might give rise to additional problems; thus nothing short of full economic analysis is often required.¹²⁴ Secondly, from a more practical perspective, not only does it make ECJ rulings even more unpredictable, thus fuelling the climate of legal uncertainty, but equally it has the side effect of extending the scope of application of what is meant to constitute an exceptional regime in the context of the EU VAT system.

More difficult to explain is the ruling in *Marktgemeinde Welden*,¹²⁵ where the Court adopted a wide interpretation of the exempt activities clause in Article 13(2),¹²⁶ paving the way for the amendments which would later emerge in the context of the recast of the former Sixth Directive.¹²⁷ Presented in 2004, the proposal for the recast of the Sixth Directive was intended to simplify and clarify existing VAT legislation. Although the Commission recognized that a number of amendments would have to be introduced in the process, it was envisaged that these would not be 'substantive', amounting to 'essentially cosmetic changes'.¹²⁸ Yet, the wording of the exempt activities clause in Article 13(2) has been altered, arguably in a substantive manner. It can be contested that the new wording reflects more accurately the original ethos of the provision, that by treating all exemptions similarly, it is in line with the principle of fiscal neutrality, and finally that the practical consequences of the amendment will be minimal. These indeed might all be very good reasons for altering the wording of Article 13(2).

This line of argument, however, misses a crucial point: the new wording of the provision has *de jure* enlarged its scope. The current VAT treatment of public sector bodies is an exception to the general rules of the EU VAT system, which gives rise to many undesirable effects. Having to

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¹²⁰ See n. 9 above, at 11 and Annex 2.

¹²¹ See, however, comments by M. Aujean, n. 112 above, at 79.

¹²² The only other item listed in the document, in relation to which there appears to have been no initiative is 'survey of various options, facilities and transitional provisions'; others items listed have also not been subject of proposal as of yet, but consultation processes are currently under way, as it is the case with 'promotions and payment cards' and 'elimination of double taxation in individual cases', see Commission of the European Communities, *Public Consultation on 'Modernising the Value Added Tax Treatment of Vouchers and Related Issues' – Summary of Results*, May 2007, and *Report on the Outcome of the Consultation on 'Introduction of a Mechanism for Eliminating Double Imposition of VAT in Individual Cases'*, Oct. 2007.

¹²³ See Section 2.

¹²⁴ As I. Roxan clearly demonstrates as regards direct taxation, see 'Assuring Real Freedom of Movement in EU Direct Taxation', *Modern Law Review* 63, no. 6 (2000): 831-876.

¹²⁵ Case C-247/95, *Welden*, [2007] ECR I-779.

¹²⁶ See detailed analysis of this case undertaken in Section 2.1.2.

¹²⁷ [1977] OJ L145/1.

¹²⁸ *Proposal for a Council Directive on the Common System of Value Added Tax (Recast)*, COM(2004) 246 final, 15 Apr. 2004, at 1-2.

deal with such a complex and flawed regime is unfortunate; enlarging its scope of application seems fundamentally unjustifiable.

6. CONCLUSION

Exemptions have been said to be ‘the fundamental structural imperfection of the common VAT system’.¹²⁹ Activities undertaken by public sector bodies, however, are not all exempt: most are outside the scope of VAT, or non-taxable, some are exempt, and yet others are taxable. Whilst, exemptions alone would have given rise to many difficulties, a regime as complex as that applicable under the EU VAT system is not only a maze of legal pitfalls, but has equally the potential to create extra economic distortions.

The jurisprudence of the ECJ in relation to the EU VAT treatment of public sector bodies is extensive and has been moderately successful in providing guidelines, which have helped clarify the regime applicable to those entities. Yet, it has not been able to resolve most of the inherent problems of the current regime, in particular

those resulting from the limited recovery of input tax; nor has it been capable of fully adapting out-dated provisions to new economic realities. Current trends towards privatization and intensified competition between public and private sectors, and demands for improved efficiency in the provision of public services, leading to increased resort to cost saving mechanisms like outsourcing, are set to continue. So far, the prevalence of these trends has resulted in a significant upsurge in the number of cases being referred to the Court, but unfortunately this has not translated into any greater legal certainty. Unfortunately, there is no obvious reason to believe that this is set to change.

Like other exclusions from the EU VAT base, the current regime applicable to public sector bodies owes its existence to a conjugation of practical and political factors which took place over thirty years ago. It is clear that the difficulties, which increasingly arise from the current regime, can only be eliminated through radical legislative reform at EU level. Unfortunately, there appears to be a shift in the opposite direction: one towards maintenance, and even extension, of the current regime to further activities.

Notes

¹²⁹ V. Lenoir, ‘April 1954–April 2004 – VAT Exemptions: The Original Misunderstanding’, *European Taxation* 10 (2004): 456–459, at 459.